Future of Banking Study

The U.S. Federal Financial Regulatory System: Restructuring Federal Bank Regulation

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THE U.S. FEDERAL FINANCIAL REGULATORY SYSTEM: RESTRUCTURING FEDERAL BANK REGULATION

by

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Introduction

Questions of whether and, if so, how the U.S. financial regulatory system—and particularly the federal bank regulatory system—should be restructured are hardly new. The debate over federal bank regulatory structure and organization goes back for nearly a century. Although studies, commissions and committees of banking scholars, high-level government officials and industry practitioners have been common, change has come only sporadically. For the most part, the U.S. financial regulatory system remains a highly decentralized system that has muddled along more or less in its present form since the New Deal reforms of the 1930s.

Most observers of the U.S. financial regulatory system would agree that if it did not already exist, no one would invent it.[1] The overlap in tasks among federal regulators and between federal and state regulators, particularly for banks, creates a confusing system that no one building a system anew would want to duplicate. That said, most observers would also admit that for all its faults, the system seems to have served both the industry and the industry's customers well—assuring a safe and sound financial system—though the inefficiencies inherent in such a patchwork system undoubtedly impose costs. For the most part, the regulated entities of the financial services industry have learned how to operate and even thrive under the regulatory system that has developed. U.S. consumers enjoy an immense array of financial products and services, and the capital markets provide funding for businesses large and small.

Nevertheless, there is value in taking a fresh look at the structure and organization of the U.S. financial regulatory system and providing some thoughtful review as to how it could

[1] See, for example, FDIC (2003a) and Spong (2000), 15.

function more efficiently and effectively. Past studies have generally confined themselves to reviewing the bank regulatory system, although many have also included the regulation of savings and loans (S&Ls) and credit unions. Although the present study focuses primarily on the federal bank regulatory agencies, it addresses other areas of the federal financial regulatory structure when appropriate.

At least part of the reason for the past focus on reform of the bank regulatory structure is that until recently, dividing financial services regulation along industry lines was relatively easy to do. In addition, banking was the segment of the industry with the greatest number of federal regulatory agencies. The financial services industry, however, has continued to evolve and become more complex. Products and services once provided by distinct industries have become increasingly similar since the 1970s (a process referred to as product and service convergence), when such innovations as money market and NOW accounts were introduced to compete with bank checking accounts. In fact, the convergence that began then has not only continued but also accelerated as the introduction of securitization and the development of derivatives markets have added to the blurring of the once-clear lines among banks, thrifts, securities firms and insurance companies.

This paper will discuss the creation and evolution of the U.S. financial regulatory system and compare its structure to that which other countries are now adopting for the regulation of their financial services industries. It will then look at past regulatory restructuring proposals and the arguments for and against reform. Major issues in designing a regulatory structure will be discussed and finally some options and a model for financial restructuring will be proposed.

The Structure, Creation, and Evolution of the U.S. Financial Regulatory System

The current system for regulating and supervising financial institutions is complex.[2] At the federal level, commercial banking organizations are regulated and supervised by three agencies—the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (Federal Reserve), and the Federal Deposit Insurance Corporation (FDIC). Thrifts are regulated and supervised by the Office of Thrift Supervision (OTS) and credit unions by the National Credit Union Administration (NCUA). The federal regulatory system also includes regulation of the securities industry by the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC),[3] regulation of Fannie Mae and Freddie Mac by the Office of Federal Housing Enterprise Oversight (OFHEO), regulation of the Federal Home Loan Banks (FHLBs) by the Federal Housing Finance Board, regulation of the farm credit system by the Farm Credit Administration, and regulation of pension funds by the Employee Benefits Security Administration in the Department of Labor and by the Pension Benefit Guaranty Corporation. The Departments of the Treasury (Treasury), Justice (DOJ), and Housing and Urban Development (HUD) and the Federal Trade Commission (FTC) play ancillary roles. Noticeably absent at the federal level is regulation of the insurance industry, which is performed exclusively

[2] Regulation consists of the laws, agency regulations, policy guidelines and supervisory interpretations under which financial firms operate. Supervision refers to the monitoring of the condition of financial institutions and to the enforcement of regulations. The bank supervisory system, for example, includes: on-site examinations and off-site monitoring of banks and bank holding companies, enforcement of banking laws and regulations, and the resolution of problem and failed banks.

[3] The SEC and CFTC oversee numerous self-regulatory organizations—including the organized exchanges, the National Association of Securities Dealers, and the National Futures Association—that provide supervision and much of the regulation for the securities industry.

by the states. In addition, each of the states regulates financial services providers which are chartered or licensed in their jurisdictions.

The federal financial regulatory system—and specifically the dual banking system, that is, the system of federal as well as state chartering and supervision of commercial banks—did not emerge until 1863, when Congress passed the National Currency Act, creating the OCC to establish a system of national banks.[4] Until that time, the states had regulated the entities in the financial system.[5] The second major step in developing a federal financial regulatory system was passage of the Federal Reserve Act of 1913, which created the Federal Reserve System. After that, not until the Great Depression—the turmoil of 1929 and the early 1930s—was there a major impetus for federal regulation of the financial system.

A flurry of regulation occurred in the early 1930s. In 1932, Congress passed the Federal Home Loan Bank Act, which established the Federal Home Loan Bank System. The following year was particularly active witnessing passage of the Securities Act of 1933, the Home Owners' Loan Act, and the Banking Act of 1933. The Securities Act addressed the need for disclosure

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[4] Technically, the federal government entered into bank regulation in 1791, when it chartered the First Bank of the United States. The bank not only operated as a commercial bank, but also assumed some of the functions of a central bank, such as acting as a fiscal agent for the Treasury. In 1811, however, the bank was not rechartered. In 1816, the federal government chartered the Second Bank of the United States, which also failed to survive. Its charter was not renewed in 1836. Not until 1863, when political pressure for a uniform national currency mounted, was a permanent federal role established in the banking industry. The National Currency Act was extensively rewritten and strengthened in the National Bank Act of 1864.

[5] The earliest banks received their charters through special acts of their state legislatures and the states played a limited role in their supervision. With the development of "free banking" in the 1830s, which allowed anyone meeting certain standards and requirements to secure a bank charter, states began supervising bank operations.

regarding debt and equity securities sold in interstate commerce or through the mails. The Home Owners' Loan Act established the federal chartering of S&Ls; it also gave the Federal Home Loan Bank Board responsibility for regulating, examining and supervising S&Ls. The Banking Act of 1933, among other things, created the Federal Deposit Insurance Corporation, which was given not only the role of providing a federal system of deposit insurance, but also the role of regulator of insured state banks that were not members of the Federal Reserve System.[6]

In 1934 Congress passed the Securities Exchange Act, the Federal Credit Union Act and the National Housing Act. The Securities Exchange Act extended the disclosure principles of the Securities Act of 1933 to debt and equity securities already outstanding if listed on national exchanges, and created the SEC. The Federal Credit Union Act provided for the establishment of federal credit unions. The National Housing Act created the Federal Savings and Loan Insurance Corporation (FSLIC) and provided for the chartering of national mortgage associations as entities within the federal government.[7] In 1935 Congress passed the Banking Act of 1935, which among other provisions, expanded the FDIC's supervisory powers.

Thus, much of the present federal regulatory system was created in the 1930s. Since then the system has been changed and expanded piecemeal. In 1940, the Investment Company Act and the Investment Adviser Act brought investment companies and investment advisers under SEC regulation. In 1956, the Bank Holding Company Act brought multibank holding companies

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[6] The FDIC was given the authority to examine all insured banks. The FDIC chose not to routinely exercise this authority in order to avoid regulatory duplication.

[7] The only association formed was the National Mortgage Association of Washington, which eventually became Fannie Mae. See: Frame and White (2004).

under Federal Reserve regulation. In 1970, the Bank Holding Company Act Amendments brought one-bank holding companies under Federal Reserve regulation.[8]

In 1966, the Bank Merger Act divided the authority to approve bank mergers among the banking agencies and DOJ, making the banking industry the only industry to have its merger activity independently reviewed outside the DOJ or the FTC. In 1967 the Savings and Loan Holding Company Act Amendments provided for the regulation of savings and loan holding companies by the FSLIC. In 1970 the Federal Credit Union Act Amendments established the National Credit Union Administration as an independent agency to regulate federal credit unions; it also established federal credit union insurance under the National Credit Union Share Insurance Fund. Also in 1970, the Currency and Foreign Transactions Reporting Act and the Bank Secrecy Act brought the Treasury into the picture, allowing it to monitor large cash and foreign-currency transactions.

In the late 1960s concerns about consumer protection gained prominence as consumer credit and consumer credit instruments began growing rapidly. These concerns led to the passage of federal laws that expanded consumer protection to the financial services industry. In 1968 the Consumer Credit Protection Act, which included the Truth in Lending Act (TLA), gave the Federal Reserve rulemaking authority for truth-in-lending, although enforcement of TLA is the responsibility of all the federal financial regulators for depository institutions and the FTC for

[8] Especially important to the issue of regulatory restructuring is how banks and their holding companies are regulated. Passage of the Bank Holding Company Act and its amendments placed oversight of bank holding companies (BHCs) with the Federal Reserve. This meant that, effectively, BHC regulation was separated from bank regulation; each was put on its own track; the result was overlap, duplication, and conflicts of purpose—if not of interest—that had not existed previously. Golembe (2000), 3.

non-depository lending institutions, such as mortgage and finance companies. Also passed in 1968 was the Fair Housing Act, which is administered by HUD and enforced by the federal financial regulators. In 1970 the Fair Credit Reporting Act was passed, which the FTC administers; the federal financial regulators examine depository institutions for compliance under the act.

The S&L crisis of the 1980s led to the establishment of a new federal regulatory agency for thrifts: in 1989, the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) abolished FSLIC and the Federal Home Loan Bank Board and created, in their place, the OTS to regulate and supervise thrifts.[9] FIRREA also established the Federal Housing Finance Board to regulate the FHLBs. Then in 1992 the Federal Housing Enterprises Financial Safety and Soundness Act created OFHEO to oversee Fannie Mae and Freddie Mac, which had previously been regulated by HUD and the Federal Home Loan Bank Board.[10]

The laws identified above form the legal basis of the federal financial regulatory system. The list is not exhaustive.[11] Various other laws govern the regulation of U.S. financial markets and institutions—such as those affecting trusts and pension plans. Although many of the newer laws have focused on consumer protection, a number of others have addressed issues of regulation and supervision related to concerns about safety-and-soundness. The latter group includes the International Banking Act of 1978 and the Federal Deposit Insurance Corporation

[9] The insurance function for savings associations was transferred to the FDIC.

[10] Although Fannie Mae and Freddie Mac have one regulator and the FHLBs have another, all of them constitute the housing GSEs (government-sponsored enterprises).

[11] See Spong (2000) for a description of banking regulation and the laws faced by banking organizations.

Improvement Act (FDICIA) in 1991.[12] The Gramm-Leach-Bliley Act of 1999 (GLB) formalized the use of functional regulation for financial services conglomerates and entrusted supervision of newly created Financial Holding Companies (FHCs) to the Federal Reserve.[13] The Sarbanes-Oxley Act of 2002, in addition to addressing issues of corporate governance, expanded the powers of the SEC and established the Public Company Accounting Oversight Board.

This complicated regulatory structure came about because financial regulation has been responsive to several traditional themes in U.S. history.[14] Among them are a distrust of concentrations of financial power, including a concentration of regulatory power; a preference for market competition; and a belief that certain sectors of the economy should be ensured access to credit, a belief that has led to a multiplicity of niche providers of credit. The nation's complex regulatory structure was designed to deal with all of these sometimes conflicting objectives.

It is precisely because the patchwork nature of the system remains an artifact of U.S. politics that there has been no comprehensive overhaul of the federal financial regulatory system.[15] Despite the complexity of the system and the resulting plethora of proposals for

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[12] The International Banking Act applied federal regulation to foreign banks. In 1991, FDICIA not only tightened the regulation and supervision of U.S. banks and thrifts, it also incorporated the Foreign Bank Supervision Enhancement Act under its Title II provisions.

[13] A discussion of functional regulation is provided below. Briefly, functional regulation is regulation of a common activity or product by a single regulator for all types of financial institutions.

[14] Horvitz (1982), 44.

[15] As Golembe (2000) has observed, "In a country possessing immense natural resources, the development of which depended to a considerable extent on financing, banking—how it would be organized and who would control it—became major political issues. Political parties were often formed around, or came apart because of, views on

change, concerns about concentrations of power, preservation of the dual banking system, and the role of the central bank, among other issues, dominate the debate, now as in the past. The repeated failure of proposals to reform the system suggests how sensitive the issues are for the many varied interest groups involved.[16]

International Trends in the Regulation of the Financial Services Industry

At the same time that questions are increasingly being raised in the United States about our fragmented, piecemeal system of financial regulation, in many other countries functional regulation has given way to consolidated supervision by a single regulator.[17] Although many countries continue to regulate and supervise their financial institutions through multiple entities (ministries of finance, central banks, and specialized independent agencies), in nation after nation, serious study and thought have been given to devising regulatory arrangements to deal with a new, more integrated, financial world. The trend has been to bring together in one agency financial supervision and regulation of the major types of financial institutions (banks, securities firms and insurance companies). In addition, many nations are achieving this consolidation by moving the regulatory and supervisory functions outside the central bank.[18]

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banking. The result was 'free banking,' 'dual banking,' and deposit guarantee. All were products of their time, all are still alive, and all help account for the present fragmented regulatory structure." (p. 3)

[16] Bush Task Group (1984), 33.

[17] Functional regulation and consolidated supervision are discussed below. Briefly, consolidated supervision is supervision of all parts of a financial organization as one entity.

[18] De Luna Martinez and Rose report that, of the 15 systems they examined in detail, 14 have created a separate supervisory agency outside the central bank. They go on to warn, however, that not all of the newly created agencies are as powerful as they seem. Ministries of finance and central banks continue to play a key role in issuing and

The Emergence of Consolidated Supervision

Starting in the mid-1980s a number of counties examined their financial regulatory structures and concluded that changes were needed. Researchers at the World Bank recently reported that at the end of 2002, at least 46 countries had adopted a model of unified (or integrated) supervision, either by establishing a single supervisor for their entire financial sector or by centralizing in one agency the powers to supervise at least two of their main financial intermediaries.[19]

In general, countries that have adopted integrated supervision believe that a single supervisor is more effective than multiple supervisors in monitoring risks across financial institutions and responding to real or potential threats that may undermine the stability of a financial system. Adoption of the new regulatory regimes has been motivated largely by concerns that the old regulatory structures—which were organized by and focused on types of institutions—were becoming increasingly, and perhaps dangerously, disconnected from the realities of the marketplace. In the marketplace, distinctions among financial products and services are increasingly converging so that many of the delineations among products, services, and types of institutions are becoming irrelevant. The new regulatory structures taking shape

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amending prudential regulations, authorizing licenses, and establishing important laws for the entire financial system. See: De Luna Martinez and Rose (2003), 12.

[19] Ibid.

around the world represent efforts to keep supervision meaningful and effective in a rapidly evolving financial environment.[20]

Although the trend is toward integrated supervision, there is variation in the scope of regulatory and supervisory powers the consolidated agencies have been given. Of the 46 countries that have adopted some form of consolidated supervision, 22 (beginning with Norway in 1986) have consolidated the regulation and supervision of financial institutions into a single supervisory authority. In the remaining 24 countries the powers to supervise at least two of the main financial institutions—such as banks and securities firms or securities firms and insurance companies—have been centralized in one agency.[21] In the latter approach, although multiple supervisory agencies remain, they have separate distinct functions. Overall, the structure and organization of the supervisory system has been rationalized to reflect the belief that one supervisor can more effectively monitor and respond to risks within a financial institution than can multiple supervisors. The United Kingdom represents the first approach (a single supervisory authority), and Australia represents the second (multiple supervisory agencies but integrated supervision).

[20] "Financial innovation and globalization, driven by an interactive process of new information technology, competition and deregulation, are, unquestionably, progressively blurring the traditional boundaries between different forms of financial intermediation. So regulation based on particular categories of institution has increasingly become overlaid by functional regulation. This has made the whole regulatory structure increasingly complex, both for the regulated firms and for the consuming public at large." George (1998).

[21] De Luna Martinez and Rose (2003).

Table 1 presents a list of those countries that, as of the end of 2002, had adopted integrated supervision, either with a single supervisor or with multiple supervisors that cross traditional industry lines.

Table 1
Countries That Have Adopted Integrated Supervision

Single Supervisor	Agency Supervising Two Types of Financial Institutions
Austria	Australia
Bahrain	Belgium
Bermuda	Bolivia
Cayman Islands	Canada
Denmark	Chile
Estonia	Colombia
Germany	Dominican Republic
Gibraltar	Ecuador
Hungary	Egypt
Iceland	El Salvador
Ireland	Finland
Japan	Guatemala
Latvia	Kazakhstan
Maldives	Luxembourg
Malta	Malaysia
Nicaragua	Mauritius
Norway	Mexico
Singapore	Peru
South Korea	Slovakia
Sweden	South Africa
United Arab Emirates	Switzerland
United Kingdom	Ukraine
	Uruguay
	Venezuela

Source: DeLuna Martinez and Rose (2003).

Integrated Supervision with a Single Regulator

The most prominent example of the trend toward regulatory consolidation is the United Kingdom, whose government moved in 1997 to establish a single regulatory authority—the Financial Services Authority (FSA).[22] In so doing, the U.K. government decided not only to consolidate all financial services regulation within one supervisory agency, but also to move that function outside the central bank. In terms of regulatory restructuring, this was the shot heard round the world. Created as an independent agency, the FSA is responsible for regulating and supervising all forms of financial services activity; it combines the regulatory and supervisory functions previously carried out by nine bodies.[23]

In describing the initial steps taken to establish the FSA its chairman, Howard Davies, focused on the development of a Complex Groups Division. This division has become the lead regulator for 40 to 50 institutions—banks and others—whose scale of operation is significant within the United Kingdom, which have a material international presence, whose products and services span a wide area and which are complex or innovative and require advanced risk-management techniques. Other institutions are supervised by other divisions within the FSA, such as the Banking Division or the Insurance Division. Thus, within the FSA there is functional regulation. This realignment of responsibilities is based on a distinction between wholesale and

[22] Although the United Kingdom was not the first country to institute this type of regulatory change, it is cited as the quintessential example of the type.

[23] The nine are the Supervision and Surveillance Division of the Bank of England, the Building Societies Commission, the Friendly Societies Commission, the Insurance Directorate of HM Treasury, the Investment Management Regulatory Organization, the Personal Investment Authority, the Registry of Friendly Societies, the Securities and Futures Authority, and the Securities and Investments Board.

retail businesses and is an attempt to ensure the adequate oversight of a rapidly changing financial services industry.

Integrated Supervision with Multiple Regulators

The Australian model illustrates a supervisory system that has been consolidated, but has multiple supervisors. Like the United Kingdom, Australia has moved toward regulatory consolidation outside the central bank, but unlike the United Kingdom, Australia has drawn a sharp distinction between "prudential regulation" (safety-and-soundness regulation) on the one hand, and regulation to ensure market integrity and consumer protection, on the other hand. Australia has placed responsibility for the two in separate regulators.

Following the recommendations contained in the final report issued by the committee established by the government to make recommendations (the Wallis Committee), Australia established its centralized regulatory system in 1998.[24] Responsibility for market integrity and

[24] In 1996 the Australian government established an inquiry to study developments in the financial industry and to make recommendations for improvements in the system of regulatory oversight of the industry. The inquiry was formally called the Financial System Inquiry, but informally the Wallis Inquiry or the Wallis Committee, after its Chairman, Stan Wallis**.** Ian Harper, a member of the Wallis Committee, summarized the committee's view of the changing financial services environment and the regulatory alterations that were proposed: "A chief rationale for re-configuring financial regulation in Australia was, as in Britain, the increasing dominance of function over institutional form. Financial functions, like the provision of payments services, the acceptances of deposits and the provision of insurance, are no longer confined to established institutions. The range of functions performed by banks and insurance companies is converging. Our financial system, modeled on the British example, established regulatory authorities on institutional lines, with separate regulators assigned to different institutions. The

consumer protection now lies with the Australian Securities and Investments Commission (ASIC), while prudential regulation has been vested in the Australian Prudential Regulation Authority (APRA). ASIC's jurisdiction extends across institutions and the financial system, and covers investment, insurance, and superannuation (pension) products. APRA provides prudential regulation of superannuation, insurance, and deposit-taking institutions. The Reserve Bank of Australia (the central bank), although it no longer has supervisory responsibilities for individual institutions, retains its responsibilities to protect the payments system and the broader economy from inflation and financial instability.

Lessons Learned

Although these systems are too new to have been tested in a financial crisis, some insights can be gained from the thinking that went into their establishment. In addition to the concerns cited above about regulation in a world of integrated financial institutions, an insight of particular importance is that information sharing and cooperation between the supervisory authority and the central bank are necessary and need to be actively cultivated. In the development of these new authorities, much thought was given to establishing channels of communication.

In the United Kingdom, for example, a memorandum of understanding (MOU) was implemented among the Treasury, the central bank, and the new Financial Services Authority. This MOU defines the responsibilities of each of the parties in relation to financial stability and

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convergence of functions dictates the creation of a regulatory agency whose responsibilities focus on function and transcend now-outmoded institutional distinctions." Harper (1997), 33-34.

provides a structure for the necessary cooperation among the parties.[25] In addition, there is cross-membership between the boards of the FSA and the Bank of England, and staff has developed close working contacts.

In Australia, the Council of Financial Regulators was formed to bring together the APRA, the ASIC, and the Reserve Bank. The council provides a forum for sharing information and views, harmonizing regulatory and reporting requirements, identifying issues and trends, and coordinating responses to situations of financial instability or uncertainty.

A Need for Reform? Arguments and Past Proposals

Proposals for regulatory restructuring have a long history in the United States and the arguments for and against reform are well known. The arguments for reform focus primarily on the issues of regulatory overlap and duplication while the arguments against focus on the notion that despite its faults, the present regulatory system works well. Virtually every study of the federal financial regulatory system has recommended some form of regulatory reform. The goal of most of the studies has been to streamline regulation within the banking industry so that there is less overlap among the federal regulators and fewer federal regulators examining the same banks and bank holding companies. The repeated failure of proposals to reform the federal financial regulatory system suggests the sensitivity of such plans for the many varied interest groups.[26]

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[25] George (2000).

[26] See Bush Task Group (1984), 33.

Arguments for Regulatory Reform

As mentioned above, the debate about reform is grounded in the complexity of the U.S. financial regulatory system. The complexity of the system has several undesirable consequences that reformers seek to mitigate or eliminate.

Overlap and duplication. The system as it has evolved entails substantial overlap and duplication in the regulation and supervision of financial institutions, especially BHCs. It is common for BHCs and their subsidiaries to have more than one federal bank regulator and for their roles to overlap. For example, in its examination of national banks the OCC looks at a bank's interactions with its nonbank affiliates; the Federal Reserve frequently repeats part of this process when it looks at nonbank subsidiaries in connection with its inspection of bank holding companies. Further, as the permissible activities of financial conglomerates have expanded, so has the potential for overlap and duplication between bank and other financial services regulators. Under GLB, for example, the securities broker-dealer of an FHC is regulated by the SEC, but the Federal Reserve is its umbrella supervisor. Another often cited area of duplication is in antitrust enforcement, which is carried out by the Federal Reserve, the DOJ, and the states.

The overlap and duplication in agency jurisdictions requires agencies to manage their shared responsibilities to try to minimize the time and money required to perform their tasks. Coordination among agencies is required for dealing with failing institutions and for developing uniformity in examinations and information collection. The difficulty in coordinating regulatory actions and procedures, however, results in inefficiencies—delaying the resolution of issues. Such delays can impose a significant burden on financial institutions, possibly raising the cost of product development or deterring it entirely.

Overlap and duplication of responsibilities can also result in conflicting rulings from the regulatory agencies that can be difficult to resolve and that can create opportunities for the same regulation or law to be applied unevenly to different institutions—potentially resulting in a less than level playing field.[27] The current system of regulatory specialization may create artificial advantages or disadvantages for particular types of competitors. As financial institutions and the products they offer have become more similar and increasingly compete with one another, differences in regulatory controls are much more likely to artificially influence the behavior of financial institutions and their customers. This may occur, for example, when banks, insurance companies, securities firms, or others compete in the same product arena, but are not subject to a common set of regulatory requirements or when those requirements are subject to interpretation and are, therefore, applied differently by various regulatory agencies.

The conflicting decisions that are possible when there is overlap and duplication of regulatory authority may also reflect a deliberate attempt by one regulator to benefit its constituents or gain converts by adopting a permissive regulatory policy—what has been termed a "competition in laxity."[28] What some may see as a competition in laxity, however, others may see as part of a dynamic process of regulatory competition that furthers innovation in the financial services industry.

Unclear authority and lack of accountability. The current system also has engendered debate over who has the authority to regulate and supervise financial institutions and their

[27] Bentsen (1994).

[28] Horvitz (1987), 129.

products and services. In the 1980s, the Federal Reserve and the FHLBB engaged in a dispute about who was entitled to have a NOW account.[29] The FHLBB adopted a more liberal regulation for savings and loans than the Federal Reserve adopted for commercial banks. More recently, federal bank regulators disagreed with the SEC regarding proposed rules to exempt banks from being treated as brokers. Although the quality of the resolutions in these instances would not necessarily have been better had there been only one agency making the decision, when ultimate authority for a particular problem is not clearly identified, the regulatory system may lose some of its effectiveness and its ability to maintain safety and soundness may be impeded.[30]

In addition to blurring the lines of authority, the current federal financial regulatory system makes it hard for any one agency to be held accountable for its actions or lack, thereof. Such an absence of regulatory accountability enables regulators to pass the buck but, more importantly, it may leave holes in the regulatory structure—regulatory gaps—that should not go unfilled. The complicated structure of regulation may lead to some problem or abuse not being detected, because a particular agency believes the problem lies in some other agency's jurisdiction. Determining if there are deficiencies in laws or regulations may be difficult when those laws or regulations are administered by multiple agencies.

Arguments against Regulatory Reform

Critics of regulatory reform proposals have been effective at preventing a wholesale restructuring of the federal financial regulatory system and are likely to continue being effective.

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[29] Ibid, 130.

[30] Bush Task Group (1984), 9.

Experience suggests that the constituency for maintaining the status quo is strong. At a conference hosted by the FDIC in 2003, a number of participants expressed the view that there is little need for or likelihood of a major overhaul of the federal financial regulatory system.[31] There is ample evidence to suggest that this view is accurate, at least with respect to likelihood.

Arguments against regulatory restructuring frequently revolve around two notions—that the present system has worked reasonably well and that a single agency will not assure uniform performance in all supervisory activities. It is hard to disagree with these notions. Despite the regulatory burden imposed by the present system, banks and other financial services providers appear quite profitable and the United States has developed the broadest and deepest financial markets in the world. In addition, there is much to be said for the notion that a single federal regulator may become too bureaucratic and unwieldy.

But the corollary argument—that multiple regulators are necessary to preserve the process of dynamic tension in bank rulemaking—seems at odds with the changes that have occurred in bank regulation and supervision. Over the past 25 years much effort has been made to bring uniformity and consistency to the federal bank regulatory process. For example, recognizing that insured depository institutions faced multiple federal regulators—with sometimes conflicting rules and regulations, Congress in 1978 passed the Financial Institutions Regulatory and Interest Rate Control Act. This act created the Federal Financial Institutions

[31] FDIC (2003a).

Examination Council (FFIEC) to promote consistency in the examination and supervision of financial institutions.[32]

Supporters of the regulatory status quo also cite as important the goal of maintaining the dual banking system. Proposals for regulatory restructuring, however, have focused on regulation at the federal level and have not challenged the right of states to charter and supervise banks. Nevertheless, those opposed to regulatory restructuring would argue that having one federal bank regulator would de facto end the dual banking system. This argument does not explain the existence of one federal regulator for thrifts or credit unions or suggest how to deal with the stresses that bank mergers and consolidation have placed on the viability of the dual banking system. In addition, legislation such as the Depository Institutions Deregulation and Monetary Control Act of 1980, FIRREA and FDICIA has reduced the differences in banking regulations and powers between state-chartered and national banks and has increased the regulatory authority of the federal bank regulators vis-à-vis state regulators over commercial banks.

Over the years, a number of those opposed to regulatory restructuring have argued that—despite the inefficiencies resulting from a multiplicity of regulators—the current system promotes innovative approaches to regulation. The claim is that the current system, in effect, maintains a degree of checks and balances among regulators, and probably results in more opportunities for industry innovation and change than would a monolithic regulatory structure. The Federal Reserve, in particular, has argued that, "a single regulator would be more likely to

[32] The council is composed of the Comptroller of the Currency, one governor of the Federal Reserve, the director of the [now] OTS, and the chairmen of the FDIC and NCUA. A liaison committee comprised of five representatives from state financial regulatory agencies is also included on the council.

make sudden and, perhaps, dramatic changes in policy that would add uncertainties and instability to the banking system." [33] Others would argue, however, that innovation is driven by the marketplace, not by the regulators. Regulators mostly react to the events that drive the regulated institutions and are kept in check by congressional oversight, the courts, the press, and market pressures.[34]

Past Proposals

As mentioned above, proposals for reform of the federal financial regulatory structure have been a fairly regular occurrence in American politics. Even before the bulk of the regulatory apparatus was established in the 1930s, four bills were introduced in Congress to abolish the OCC and transfer its powers to the Federal Reserve.[35] Since 1937, numerous other proposals have been made; they are described in the appendix.

Although the proposals have varied in their approach to consolidation of the federal regulatory system (mainly the federal bank regulatory system), the goal of all of them has been to streamline the system. Some proposals seek to consolidate the federal banking regulators, and

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[33] See for example, Board of Governors of the Federal Reserve System (1994), 133.

[34] See, Bensten (1994), 56.

[35] Federal Home Loan Bank Board (1983), 157. Interestingly, one of the earliest reforms came about in 1917 through action of the agencies themselves. The Federal Reserve Act of 1913 had given both the Office of the Comptroller of the Currency and the Federal Reserve the authority to supervise and examine banks that were members of the Federal Reserve System. This overlap caused some confusion among the regulated banks. The overlap was resolved in 1917, when the Comptroller assumed responsibility for national banks and the Federal Reserve assumed supervision of state member banks.

perhaps others, into a single regulator, usually a Federal Bank Commission. A number of proposals espouse removing the Federal Reserve from bank supervision. Others would streamline the regulatory process, either with a limited consolidation of the federal banking regulators or with a shift of certain functions among the bank regulatory agencies. In general, the proposals recognized the importance—and political inevitability—of the dual banking system.

Shortly after passage of the Banking Act of 1935, the Brookings Institution undertook for a Senate committee a study of the structure of the bank regulatory system. The study suggested merging the Comptroller's Office into the FDIC. The Hoover Commission in 1949 produced three task force reports, one calling for the merger of the OCC into the Federal Reserve, one calling for the merger of the FDIC into the Federal Reserve, and one calling for the merger of both the OCC and FDIC into the Federal Reserve. The full Commission, however, concluded that the FDIC should be merged into the Treasury. In 1961 the Commission on Money and Credit wanted all banking agencies merged into the Federal Reserve, but in 1971 the Hunt Commission recommended that the Federal Reserve get out of the supervision and regulation of banks and that a State Banks Administration be established, which would assume the regulatory and supervisory responsibilities of both the Federal Reserve and the FDIC. It also recommended replacing the OCC with a National Banks Administration and making it an independent agency. A few years later, the FINE Study became the first to propose that a single, new, consolidated banking agency be created. The study recommended combining the supervisory and regulatory functions of the FDIC, Federal Reserve, OCC, FHLBB (now OTS) and NCUA into a single Federal Depository Institutions Commission. In 1984, the Bush Task Group proposed consolidating the federal regulation of banks and bank holding companies into two federal regulators—the OCC for national banks and the Federal Reserve for state-chartered banks.

Also, in 1984 the Depository Institution Affiliation Act was introduced in Congress, which would have established a National Financial Services Committee consisting of the heads of the Federal Reserve, FDIC, OCC, SEC, CFTC, and the Secretaries of Treasury, Commerce and Justice. The purpose of the National Financial Services Committee would have been to establish uniform principles and standards for the examination and supervision of financial institutions and other providers of financial services. In 1994, the Clinton Administration proposed the Consolidation Act, which would have combined the regulatory and supervisory functions of the OCC, the Federal Reserve, the FDIC and the OTS into a new independent agency, the Federal Banking Commission.

The various proposals for reform have specified their goals as promoting efficiency, ensuring the uniform application of laws and regulations to all competing institutions, reducing the confusion and regulatory burden caused by institutions' need to deal with multiple regulators, and improving agency responsiveness and accountability.[36] In 1994, the Secretary of the Treasury characterized the federal financial regulatory system as a dilapidated system ill designed to prevent future banking crises and ill equipped to cope with crises when they do occur.[37]

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[36] See Commission on Money and Credit (1963), 57; Hunt Commission (1971), 89; and Bush Task Group (1984), 27-32.

[37] Bensten (1994), 51.

Major Issues in Designing a Regulatory Structure: Structural vs. Functional Regulation, Umbrella Supervision vs. Consolidated Regulation, and the Role of the Central Bank

Despite the changes made to the financial system by GLB in 1999, the U.S. regulatory system still largely assumes a financial marketplace with well-differentiated products and services and with financial service providers that can be categorized by function. Yet many banking, securities, and insurance products and services now overlap in purpose, effect, and appearance, and financial service providers have found numerous ways around the restrictions that attempt to confine them to particular regulatory niches. The result is that the dynamic financial marketplace is in effect creating organizations that manage their risks and market their products and services as unified entities—but are subject to the oversight of a comparatively static and complex regulatory structure that looks largely at individual pieces of larger organizations. In considering how to regulate these increasingly complex entities choices have to be made between structural and functional regulation, umbrella supervision and consolidated regulation, and between whether and, if so, to what extent the central bank should be part of the financial supervisory system.

Structural versus Functional Regulation

Structural or institutional regulation is characterized by having a single agency exercise all of the different types of regulatory controls applicable to a single financial firm. It allows a single regulator to examine a firm's operations as a whole, to evaluate risk across product lines, and to assess the adequacy of the firm's capital and operational systems that support all the business lines. In structural regulation integrated supervisory and enforcement actions can be taken that will address problems affecting several different product lines. Structural regulation assumes that the financial firm being regulated serves a distinct market segment with limited overlap into other market segments.

Functional regulation, in contrast, is regulation of a common activity or product by a single agency under a common set of rules irrespective of the type of institution involved; it may artificially divide a firm's operations into departments by type of financial product or service being offered. Because structural regulation developed at a time when types of financial organizations (commercial banks, S&Ls, credit unions, securities firms, and insurance companies) provided products and services that were largely distinct from one another, structural regulation was more or less equivalent to functional regulation. A bank regulator supervised banking products and services while a securities regulator oversaw activities and products in the securities industry. Some overlap existed—such as in bank trust departments, where bank regulators performed the role of securities regulator—but overlap was not pervasive. Although many financial services firms still provide niche services, for many others the old market distinctions are invalid.

Structural regulation went unchallenged until the 1980s. By then, however, defining how one financial services firm differed from another was becoming more difficult. The advent of money market accounts, NOW accounts and share drafts; the growth of mortgage activity in commercial banks; the development of Section 20 companies; and the renewal of interest in the Industrial Loan Company charter, among other developments, led to the blurring of distinctions between types of organizations that had once been largely distinct. As the once well-defined lines separating financial services firms were being erased, the way in which these entities were regulated became problematic. The development of direct competition among different types of financial firms brought out the problem of having different regulators governing equivalent products and services. The regulatory inequities that resulted from this differential regulation hindered some firms' ability to compete and called into question their viability vis-à-vis their differentially regulated counterparts. Accordingly, the idea developed that financial firms should be regulated along functional lines.

The idea of applying functional regulation to the banking industry was first put forth in a 1982 Treasury proposal to expand the securities powers of commercial banking organizations.[38] Then-Secretary of the Treasury Donald Regan proposed that commercial banks be required to place their securities underwriting and dealing activities in a separate subsidiary, which would be subject to regulation by the SEC or National Association of Securities Dealers.[39] In 1984, the Bush Task Group endorsed the concept of functional regulation, stating that all institutions engaged in similar activities should be subject to the same regulations. Functional regulation as defined by the task group seeks to have each common activity or product regulated by a single agency under a common set of rules, irrespective of the type of institution involved.[40] The idea is

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[38] Fein (1995), 91.

[39] The policy was endorsed by SEC Chairman John Shad, who subsequently articulated the following four arguments supporting the use of functional regulation for the banking and securities industries. First, functional regulation allocates to each regulatory agency jurisdiction over those economic functions it knows best. The expertise of the banking regulators is ensuring the safety and soundness of the banking system. The expertise of the SECis protecting investors. Second, allocating regulatory jurisdiction by function would permit the application of consistent regulatory policies. Shad's contention was that how the banking regulators' approached their responsibilities under the securities laws differed from how the SEC regulators approached theirs, and this difference opened the door to questions of efficiency and fairness for the regulated entities. Third, a system of functional regulation would minimize regulatory conflict, duplication, and overlap. Fourth, functional regulation would promote the conditions for equal treatment of competitors. See: Shad (1982)

[40] Bush Task Group (1984), 40.

that functionally equivalent products and services should be regulated alike, regardless of the type of entity performing the function. GLB, which allows banks, thrifts, securities firms, insurance companies and other financial services providers to be linked through common ownership, formally incorporates functional regulation into the U.S. federal financial regulatory system.

Umbrella Supervision versus Consolidated Regulation and the Emergence of Consolidated Supervision

In its 1991 study on modernizing the financial system, the Treasury argued that a bank supervisor could not be expected to effectively regulate the complex and diverse range of businesses incorporated in a financial conglomerate. Rather, bank regulation should be concentrated on the bank, while diversified FHCs or BHCs should be subject to normal market discipline.[41] At the same time, however, it recognized that "umbrella oversight" of the financial conglomerate by the bank regulator was necessary to protect the insured depository from affiliate risk. Eight years later, GLB designated the Federal Reserve as the umbrella supervisor of the newly created FHCs.

Under umbrella supervision information is obtained in order to monitor and assess the risks that a holding company and its subsidiaries impose on an insured depository and actions are taken to control those risks. As umbrella supervisor, the Federal Reserve may take actions against affiliates of banks when those affiliates pose a material risk to the bank, but the Federal Reserve may only instigate such actions in consultation with the affiliate's functional regulator.

[41]U.S. Department of the Treasury (1991), 61.

The Federal Reserve may not establish capital requirements for or impose limits on the products of functionally regulated affiliates of the bank.

Consolidated regulation, in contrast, is about proscribing actions. The term "consolidated regulation" has generally come to designate the panoply of regulations and supervisory powers applied to BHCs—the authority to set capital requirements for the parent companies; to set limits on or prohibit activities that may be conducted in nonbank units of a BHC; and to enforce regulatory and supervisory decisions. As consolidated regulator of BHCs, the Federal Reserve has the authority to require the divestiture of affiliates that are deemed to pose a safety-and-soundness risk to the bank.[42]

Over the past decade, the concept of consolidated supervision[43]—but with a meaning that is closer to the U.S. concept of umbrella supervision—has taken hold around the world, as recognition has grown that functional regulation treats financial institutions as disparate units rather than cohesive wholes. In 1991, the Foreign Bank Supervision Enhancement Act required consolidated supervision of all foreign banks that had operations in the United States. In 1992, the Basel Committee on Banking Supervision adopted its Minimum Standards for Consolidated Supervision, establishing the principle that a bank should be subject to a supervisory regime in which its financial statements are consolidated and subject to review by home country authorities. The Joint Forum (comprising the Basel Committee for Banking Supervision, the International Organization of Securities Commissioners, and the International Association of Insurance Supervisors) furthered the trend by developing principles appropriate to the

[42] See: Carns (1995), 2.

[43] The worldwide concept of consolidated supervision focuses on the collection of information as a way to gauge the risk posed by a financial conglomerate.

supervision of entities that operate within financial groups. In 2002, the European Parliament passed a directive requiring all financial services firms doing business in the EU to be supervised on a consolidated basis by a home-country supervisor approved by the EU.[44]

Indeed, much of the restructuring of financial supervision around the world has come about because of the view that financial conglomerates need to be regulated and supervised on a consolidated basis. In developing its principles, the Joint Forum was concerned that, although individual financial companies within a group might be subject to prudential supervision, the consolidated financial group might not be subject to appropriate oversight. This lack of appropriate oversight could lead to relationships or transactions that could pose financial risk to the regulated parts of the group. The Joint Forum's principles were developed to ensure that there were no material gaps in supervisors' understanding of interaffiliate relationships within a financial group that could cause financial instability.[45]

Supervision and the Central Bank

In the United States the issue of the role of the central bank and the relationship between monetary policy and bank supervision has proved especially hard to resolve. Proposals to consolidate bank regulatory authority outside the central bank or to significantly reduce the regulatory authority of the central bank have been vigorously opposed, particularly by those within the Federal Reserve. Representatives of the Federal Reserve have maintained that such proposals are fatally flawed because they would undermine the ability of the Federal Reserve to

[44] European Union (2002).

[45] Olson (2002).

conduct monetary policy, to achieve its mission of ensuring financial stability, and to oversee a smoothly functioning payments system. According to their arguments, "These responsibilities are mutually reinforcing and are integrally linked to the banking system."[46]

In discussing the link between monetary policy and bank regulation and supervision, representatives of the Federal Reserve argue that keeping bank supervision within the central bank allows makers of monetary policy to better understand the relationship between their actions and bank behavior. In a study of the usefulness of supervisory data to macroeconomic forecasting, Peek, Rosengren and Tootell (PRT) found that confidential information obtained through bank supervision can potentially improve the accuracy of macroeconomic forecasts, a tool that is essential to the conduct of monetary policy.[47] They hypothesized, for example, that problems in the banking sector might serve as an early indicator of deteriorating macroeconomic conditions. In a follow-up study, PRT tested to determine which institutions could provide the greatest synergies for the conduct of monetary; they argued that these are the institutions the Federal Reserve should regulate.[48] A similar study by Feldman, Kim, Miller and Schmidt, however, concluded that there is no evidence to support the claim that confidential supervisory information would have improved macroeconomic forecasts in an important way.[49]

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[46] Syron (1994), 3. See also Board of Governors (1994), 132-147.

[47] Peek, Rosengren, and Tootell (1999), 21.

[48] They find that state-chartered institutions provide the most useful supervisory information and they suggest that perhaps the Federal Reserve should be responsible for supervising state-chartered institutions. (Peek, Rosengren, and Tootell (2001).

[49] Feldman, Kim, Miller, and Schmidt (2002). FKMS extend the PRT model to test it out-of-sample; they also extend the period of analysis.

The existence of a link between supervisory information and better economic forecasts would not, by itself, prove that the Federal Reserve needed to have bank supervisory powers. The Federal Reserve currently receives information about the majority of banks from the other banking regulators, both state and federal; the Federal Reserve directly regulates and supervises only 12 percent of banks, representing 25 percent of bank assets.[50] PRT acknowledge that their argument relies on the assumption that information cannot be effectively transferred between agencies, an assumption championed by officials within the Federal Reserve. "Eliminating the Federal Reserve's regulatory and supervisory function would deprive the central bank of complete information about the ways that levels of reserves, movements of monetary aggregates, and fluctuations in the federal funds rate are being affected by regulatory policy and decisions by bank management."[51]

Despite their results, PRT state that Federal Reserve staff do not incorporate supervisory information into their forecasts, "possibly because the highly confidential CAMEL ratings are not provided to staff involved in the macroeconomic forecast."[52] Rather, PRT find evidence for retaining bank supervisory powers within the Federal Reserve by noting that the governors and presidents of the regional Federal Reserve Banks are actively involved in bank supervisory issues and use this knowledge to alter the internal macroeconomic forecasts. PRT state that supervisory information is important only to the extent that the Federal Reserve understands the rating process and how it may change over time. Likewise, PRT conclude that the loss of bank supervisory responsibilities might reduce the Federal Reserve's ability to understand the nuances

[50] FDIC (2003b), 14.

[51] Syron (1994), 7.

[52] Peek, Rosengren and Tootell (1999), 30.

in supervisory data and might therefore make the data less useful for purposes of monetary policy. Nevertheless, PRT warn other countries that have reduced their central bank's oversight role that they should be careful to gather the information that is provided in supervisory reports.

Other arguments that have been put forth to justify the Federal Reserve's continuing role in bank supervision have focused on its responsibility as the lender of last resort and as overseer of the nation's payments system—roles that make the Federal Reserve more sensitive to systemic risk than other bank supervisors would be. These arguments have stressed the usefulness of supervision, for it provides a kind of hands-on knowledge of what is happening in the banking system that could not be gotten elsewhere, not even from examination reports written by examiners in other agencies.[53] In a discussion of PRT, Bernanke notes his reservations about the arguments for central bank supervisory responsibilities but states that the information transfer argument is stronger in the context of crisis management, when highly detailed and complex information must be transferred quickly.[54]

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[53] In discussing how the Federal Reserve managed to avert a banking crisis in New England in the early weeks of 1991, Syron (1994) states that the discount function has many similarities to the work of bank examiners. He explains that both of them involve the examination of loans, appraisals of collateral, and verification of secured interests. "The examiner's work was critical to our ability to respond quickly to the need for establishing sufficient collateral for discount window borrowing." (4-5) Syron also argues that other agencies limit their bank examination focus to the safety and soundness of individual institutions and the exposure of FDIC insurance funds to bank actions. The Federal Reserve must be aware not only of these considerations but also of ways in which problems can spill over to other participants and markets. Examiners who focus solely on the safety and soundness of individual banks frequently do not have the training and the interaction with payments operations that are critical in identifying possible systemic problems.

[54] Bernanke (2001), 295.

The most common argument for placing supervisory responsibility outside the Federal Reserve is that doing so would mitigate potential conflicts of interest between the conduct of monetary policy and supervision of banks. Such conflicts arise, for example, in economic downturns as concerns about safety and soundness cause banks to be procyclical in their lending behavior while monetary policy is trying to be countercyclical.[55] Moreover, this behavior is reinforced during bank examinations because the number of classified assets tends to increase in economic downturns. Regardless of whether examination standards are actually tightened during an economic downturn, the number of assets classified by examiners is likely to be procyclical. As this happens, banks are likely to adjust their lending. Thus the overall effect of the examination process may be to intensify the business cycle, an effect that would conflict with a monetary policy that was designed to be countercyclical.

It is argued that in such circumstances the Federal Reserve could apply moral suasion to bankers, urging them to increase lending during a downturn or restrict lending in an upturn. To many, however, the idea of the Federal Reserve using its leverage as regulator to persuade bankers to alter their lending decisions or to take other actions in line with monetary policy is troubling and demonstrates the danger of having the central bank regulate and supervise the banking system.[56] Although the use of moral suasion as a tool of monetary policy has always been discounted in the United States simply because of the difficulty of using it effectively with so many banks, the possibility that it could be used increases as the number of banks declines and as fewer banks hold a greater percentage of the industry's assets.

[55] Peterson (1977), 27-28.

[56] As Bernanke (2001) noted, "Giving the central bank too broad a range of powers may invite abuse. . . . The potential for moral hazard is real and should be a concern for those who supervise the supervisors." (296-297).

To determine whether and to what extent the Federal Reserve needs to be involved in the regulation of banks, BHCs, FHCs or some other financial service provider, one must judge whether the benefits for the Federal Reserve of having first-hand information about an institution outweigh the inherent potential conflicts when the conduct of monetary policy is combined with supervision. Is it possible to get an accurate picture of the financial system from information provided by others directly responsible for regulation and supervision? Will the central bank have the tools it needs to deal with a crisis? In other parts of the world the answer has been to place supervisory responsibilities outside the central bank, but these structures are relatively new and have not yet been tested in a crisis.

Options and a Model for Restructuring the Federal Financial Regulatory System

In thinking about a restructuring of the federal financial regulatory system, one should begin by considering the reasons for regulating the financial system. An overriding parameter of any restructuring proposal should be to build a system that minimizes access to the federal safety net while ensuring that the institutions that are being regulated are viable, competitive, and capable of meeting the needs of their customers. One should also consider how events, which are now playing out or which are likely to occur, may propel adjustments to the system—whether incremental or wholesale. After examining these matters, the paper discusses the incremental approach to reform and then offers a model for comprehensive restructuring.

Goals of Regulation

Although some would argue that regulation exists because of the provision of the financial safety net—specifically, access to the discount window and deposit insurance—in fact, the evolution of the regulatory structure over the years suggests that even without a safety net, some degree of regulation, particularly to protect consumers, would exist. As the federal financial regulatory structure evolved, three goals emerged: to ensure the safety and soundness of the financial system, to foster efficiency within and competition among financial institutions, and to protect consumers.

Ensuring safety and soundness. The principal goal of the federal regulation of depository institutions is to ensure their safety and soundness and by so doing promote stability within the financial system. Operationally, this means that disruptions in the financial system should not have a significant effect on aggregate real economic activity. Thus, the failure of even a large financial institution should not be a concern unless the failure is allowed to propagate or become systemic.[57] Because the provision of deposit insurance eliminates the incentive for insured depositors to monitor and discipline their banks (that is, it creates moral hazard), someone else must assume the function of monitoring bankers and preventing them from taking excessive risks. In the United States, this responsibility has fallen to bank regulators who fulfill this function primarily through safety-and-soundness regulation and supervision.

Ensuring a safe and sound banking system and promoting financial system stability while undertaking regulatory restructuring require balancing this need for effective regulatory oversight with the possibility that too much regulation can have the opposite effect—too much regulation can hinder an entity's ability to compete or induce an entity to undertake risky activities that it would otherwise not undertake. Fulfilling this goal also requires developing a system that limits

[57] Hoenig (1996), 7.

the extension of the financial safety net in order to encourage market, as well as regulatory, discipline.

Fostering efficiency and competition. Fostering efficiency within and competition among regulated institutions so that customers are provided quality products and services at competitive prices is another goal of regulation. Efficiency and competition are closely linked. Efficiency is promoted by fostering fair and equal competition among firms. In a competitive financial system firms must operate efficiently in order to keep their customers and remain in business. Competition also spurs innovation.

To maintain a competitive system, regulators must be concerned with such issues as the prevention of excessive concentration of economic power, and the ease of entry into financial markets. Regulators must also consider the allocation of resources among financial firms, promoting competitive standards that do not differ significantly among financial institutions and that do not place some financial firms at a disadvantage relative to others—what has otherwise been termed, maintaining a level playing field. Another goal of regulatory reform, therefore, should be to foster efficiency in regulated entities and to ensure a level playing field for all competitors.

Protecting consumers. Protecting consumers (including consumers as investors) is the third goal of federal financial regulation and covers such concerns as enforcing contracts, protecting consumers against fraud, and providing full and accurate information on the terms and conditions of obtaining credit or purchasing financial products. Much of the legislation and regulation in this area is concerned with maintaining market integrity—providing meaningful disclosure in order to afford consumers and investors a basis for comparing and making informed choices among different products and services. Equal treatment and equal access to credit are also important objectives. More recent legislation focuses on privacy concerns.

As discussed above, consumer protection regulation in the financial services industry is administered by a variety of agencies, and can result in differential regulation and the inequitable treatment of firms competing in the same market. Members of the public can suffer too, if they receive different levels of protection when they purchase similar products or services from different financial firms, or if differences in the application of laws and regulations hinder their ability to compare products and services. Here too, rethinking the regulatory system in light of the realities of the changing marketplace could lead to better consumer protection.

Future Problems that Will Affect the Regulatory Structure Debate

Regardless of whether one believes that regulatory reform is likely, events and issues are sure to stimulate discussion of it in coming years. Among such issues are funding for the OCC and OTS,[58] disagreements between the federal and state banking regulators over rights of preemption,[59] questions over how financial firms should be regulated for compliance with anti-

[58] Consolidation among banks has affected the funding of both the OCC and OTS and has raised questions about how state banks are charged for their own supervision. Additionally, as the thrift industry continues to shrink, the role of the OTS becomes more problematic: legislation has taken away the advantages of operating thrifts, and a declining industry is unlikely to be able to support an independent agency.

[59] Both the OCC and OTS have been active in preempting certain state consumer laws affecting the institutions they regulate. See: OCC (2003).

money laundering and other anti-terrorist financing regulations,[60] growth in the number of issues that cross the lines separating functional regulators,[61] the need to provide consolidated supervision for financial service firms that are interested in operating in the European market,[62] consideration of the expansion of the products and services offered by ILCs,[63] and a widening of the differences between the largest banking organizations and the rest of the banking industry, including differences between them in risks posed.

The options outlined below range from the least intrusive and most easily accomplished reforms—ones which regulators could undertake themselves or that require little legislative change—to a full-scale restructuring of the federal financial regulatory system. There are valid

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[60] Recent controversies regarding the vigilance with which anti-money laundering and anti-terrorist financing laws have been enforced by bank regulators have led to questions about whether this function should be administered elsewhere. Administration of these laws is the responsibility of Treasury and involves coordination with many agencies, both in the United States and abroad.

[61] As banks, securities firms and insurance companies continue to find ways to compete with one another, it will become impossible to separate banks from the larger financial services industry of which they are a part. Thus issues will arise between regulators over how similar products and services are regulated and who has ultimate jurisdiction over them. For example, the SEC and federal banking regulators have differing views on the issue of how to apply brokerage rules to banks.

[62] For BHCs and FHCs and their subsidiaries operating in the EU, the Federal Reserve provides consolidated supervision; however, other financial service providers operating in the EU will be regulated by the EU if they do not have a consolidated supervisor. Recently, the SEC recently issued a proposal to provide consolidated supervision for broker-dealers that meet minimum capital requirements; one of their reasons for doing so is to allow these broker-dealers to meet the EU requirements.

[63] Questions about the regulation of ILCs have increased as the number of commercial companies and others that are not regulated as BHCs seek to acquire this charter. For a further discussion of the issues posed by ILCs and the mixing of banking and commerce, see: Blair (2004).

arguments for taking either approach or even for finding some middle ground, such as a thorough restructuring only of federal bank regulation rather than of the entire financial regulatory system. Within each option there is room for debate over how regulation might be structured—for example, which financial entities might be included.

An Incremental Approach to Regulatory Restructuring—What Can Regulators Do?

Given the difficult political questions that would have to be resolved if the federal financial regulatory structure were to be changed, a number of observers have recommended that any approach taken be incremental. The benefit of an incremental approach (which would involve simplification rather than consolidation) is that it would be likely to spark less debate that would stymie action and it would not limit the options for later reform. Simplification (such as eliminating redundancies in current supervisory policy) would not tread on the dual banking system, nor would it limit the central bank's authority to obtain whatever data it might need to play its role in the nation's financial system. Simplification effected by the agencies themselves would give decision makers time to evaluate and correct their actions as they went along. It might also be achievable because it would require neither legislation nor a crisis.

At a conference hosted by the FDIC a number of speakers made explicit suggestions for initiatives that the regulatory agencies could undertake.[64] Chief among these were for the agencies to develop ways of sharing resources and various kinds of expertise. It was suggested, for example, that the Federal Reserve could take the lead in setting and enforcing risk-based capital rules, and the OCC could take the lead in defining and enforcing rules for the sale of non-

[64] FDIC (2003a).

deposit investment products. Under such a scheme, other regulators with jurisdiction over an institution would be required to abide by the judgment of the lead agency in the specific area. Disputes would be resolved among the agencies, each of which would have the right to review reports generated by the others. Other suggestions along this line included having the regulatory agencies contract with each other when in need of specialized expertise rather than building it in-house, or having regulators establish cross-agency teams to supervise specialized institutions regardless of a particular institution's charter.[65]

Another way for agencies to streamline the regulatory process is by improving the rulemaking process. Disagreements and inconsistencies among the regulatory agencies make for bad policy, increased confusion, and increased costs for supervised institutions.[66] Sheila Bair has proposed that the federal financial regulatory system move toward integrated rulemaking while maintaining separate supervisors.[67] Other suggestions are for the agencies to specify what regulations are outmoded and how they can be changed. The EGRPRA project currently headed by the FDIC is making progress in this area.[68]

Overhead is another area where regulators may be able to achieve efficiencies and reduce the cost of regulation, both for themselves and for the firms they regulate. For example, each of the federal bank regulators maintains its own headquarters and regional offices, its own administration and personnel staff, its own computer system, its own contracting offices, its own

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[65] Stern in FDIC (2003a).

[66] Lazio in FDIC (2003a).

[67] Bair in FDIC (2003a).

[68] The EGRPRA project refers to reviews the regulatory agencies must conduct every ten years under the Economic Growth and Regulatory Paperwork Reduction Act.

data collection and dissemination facilities, its own economic analysis and research function, and its own training facility. The FDIC has estimated that the OTS, the OCC, and the FDIC spend in total more than $200 million annually on backroom operations to support their supervisory activities.[69] Sharing these functions may be one way to reduce costs, increase the sharing of information among the bank regulators, and ease the regulatory burden on the industry.

Comprehensive Restructuring—A Possible Model for Reform

An approach that contrasts with the incremental option is to think about how one would develop a system of federal financial regulation if one were starting anew. Such an attempt at comprehensive reform raises complex issues regarding dual banking (or more generally, the role of the federal and state governments in regulation); deposit insurance and the extension of the financial safety net; and the role of the Federal Reserve. Many proposals have foundered because they were unable to generate consensus on these issues. The model presented here will undoubtedly also spark controversy, but nevertheless presents a framework for comprehensive reform. The discussion is based on three assumptions: that the dual banking system will remain; that the Federal Reserve will intervene in a systemic crisis and needs the tools to do so effectively and efficiently; and that the deposit insurer needs to be able to control its risk.

The model will have to deal with three questions. The first concerns financial conglomerates, the second concerns the two-tiered nature of the banking industry, and the third concerns the relationship between consumer protection regulation and prudential (safety-and-soundness) regulation.

[69] Powell (2002).

Banks have been subject to the most rigorous regulation and supervision in the financial services industry mainly because of their "special" nature,[70] but financial modernization and the movement toward financial conglomerates have lessened the special distinctions between banks and other financial service providers, and have increased the types of financial organizations that may be capable of posing a systemic risk to the financial system. Many of these large financial conglomerates do not fall under the purview of the safety-and-soundness regulation of the federal bank regulators. Accordingly, in designing a financial regulatory system, one needs to decide whether these entities should be regulated in the same manner as BHCs or whether the regulation of BHCs should change to be more like that currently applied to nonbank financial conglomerates. However the issue is resolved, regulatory restructuring should be concerned with creating a more uniform approach to all large financial conglomerates.[71]

The second important issue when one is modeling a regulatory system is how to deal with the fact that financial products and services are provided by a two-tiered industry. Over the past decade the introduction of new products and services, the process of product and service convergence, and the ability of banks to expand their operations across state lines have created a bifurcated banking industry. Current regulatory practice recognizes this bifurcation and makes some adjustments for it.[72] In considering reform of the regulatory system, however, one must

[70] The special nature of banks has been widely discussed. It focuses particularly on the ability of banks to offer transactions services and administer the payments system, their role as providers of backup liquidity to the economy, and their role as transmitters of monetary policy. See: Corrigan (1982), 2-24. Banks also have access to the federal financial safety net.

[71] See, for example, Raines (2004) and McDonough (1997).

[72] See: Powell (2004) and Meyer (1999).

consider whether these adjustments are adequate, or whether the differences between “small” and “large” financial service providers warrant separate regulatory and supervisory treatment. As FDIC Chairman Powell has asked, “How do we design safety-net arrangements to work most effectively in an industry consisting of a few large banks on one side and thousands of community banks on the other?”[73]

The last question affecting the model outlined below is whether consumer protection regulation and investor protection (termed market integrity) regulation would be more effectively and efficiently administered by those who administer safety-and-soundness regulation or by an independent entity. As the discussion above of the U.K. and Australian systems indicates, opinions differ.

The model that follows would reconfigure the current system of federal financial regulation into four independent agencies. One would administer all consumer protection regulation for the financial services industry. Two would administer the safety-and-soundness regulation deemed necessary for federally insured depository institutions and their parent companies and affiliates; one of the two would administer the regulation for small and noncomplex institutions, the other for large or complex institutions.[74] The fourth agency would administer the federal deposit insurance programs for all insured depositories. In addition, the Federal Reserve would have authority to require information from or conduct examinations of any financial institution deemed to pose a systemic risk to the financial system regardless of its insurance status. The model also considers antitrust enforcement and state-chartered institutions.

[73] Powell (2004).

[74] Complexity refers to the scope of products and services offered by the the financial entity and the degree of risk inherent in those products and services.

The model is based on the size and the degree of complexity of a particular financial organization. The vast majority of financial organizations are not large and complex, and for this majority, regulation of the insured financial entity without the need for consolidated regulation or umbrella supervision of the parent company should be sufficient.[75] For large or complex organizations, however, an additional layer of supervision (in the form of umbrella supervision of the parent company and the nonbank affiliates—termed, enterprise supervision) is needed to ensure that risk is being managed across the entity.

The key question, therefore, is no longer which industry a financial organization fits into, but whether the institution is large or complex. In any event, for all institutions a case could be made for putting consumer protection in the hands of a single regulator (that is, for functional regulation). Much of the regulation protecting consumers crosses industry lines and in these areas consumers of financial products would likely find it easier to deal with one regulator rather than with the current maze of regulators.

Consumer protection and market integrity regulator. The regulator for consumer protection would administer federal consumer-related and investor-related regulations for *all* financial service providers. This agency would take over the regulation and supervision of depository institutions with respect to consumer protection laws and would administer the current functions of such agencies as the SEC, the CFTC, the Employee Benefits Security

[75] At the end of 2003, over 96 percent of BHCs that filed reports derived more than 90 percent of their revenues from banking operations. In fact, only 16 BHCs reported that more than 25 percent of their revenues were earned from nonbank sources.

Administration of the Department of Labor, and the Pension Benefit Guaranty Corporation, among others.

Over the past several years, emphasis has also been placed on obtaining strategic law-enforcement information gathered from reports supplied by a variety of financial services firms. Enforcement of the Bank Secrecy Act and other anti-money laundering and anti-terrorist financing laws, currently carried out by federal bank regulators in conjunction with the Treasury and the Department of State, among others, could also be consolidated under this regulator.

Safety-and-soundness regulator for relatively small, noncomplex insured depository institutions. This agency would be the federal safety-and-soundness regulator for relatively small, noncomplex insured depository institutions regardless of charter.[76] This regulator would have the authority to grant federal charters, establish capital requirements, enforce prompt corrective action, collect information necessary for the timely monitoring of the institution, and take action to ensure that firewalls were not breached.[77]

If insured depository institutions were part of a larger organization, they should be separate affiliates within a holding company structure. The parent holding company and its non-banking subsidiaries would be unregulated, although they would be required to provide such information as would be necessary for the regulator to determine that firewalls were not being

[76] The size of the institution is based on that of the insured entity or sum of entities, if there are multiple affiliated insured institutions. The exact definition is problematic and beyond the scope of this paper to determine.

[77] For a discussion of firewalls and Section 23A and 23B restrictions and their purpose, see: Blair (2204).

breached. This information would be obtained through supervision of the regulated financial entity—a "bottom-up" approach to bank regulation like that currently practiced by the FDIC.[78]

Safety-and-soundness regulator for other insured depository institutions. This agency would be the federal safety-and-soundness regulator for insured depositories that are deemed large or complex or that are part of a large, complex financial conglomerate.[79] As above, if the insured depositories are part of a larger organization, they should be separate affiliates within the holding company structure. Also, as above, the regulator should focus on the insured entity, which has access to the federal safety net. The regulator would have the authority to establish capital requirements, enforce prompt corrective action, collect information necessary for the timely monitoring of the insured entity, and take whatever action was needed to ensure that firewalls were not breached.

Because institutions that are part of a financial conglomerate are generally perceived by the market as one entity, it is especially important for this regulator to be able to ensure that the veil of corporate separateness is maintained between the insured depository and its parent and affiliate companies.[80] This regulator would therefore supervise the parent holding company and

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[78]Through its authority to regulate and supervise banks, the FDIC can currently examine any affiliate of an insured entity to ascertain its relationship with the insured entity and the effect of that relationship on the insured entity. The FDIC has a host of powers that allows it to limit—severely in some circumstances—a holding company's ability to direct the affairs of a bank.

[79] As one would expect, any depository institution that does not fall into the category of small and noncomplex would be placed here.

[80] See Helfer (1997), 10: "In view of the increasing complexity of the financial marketplace, functional regulation alone may not be sufficient to ensure effective and efficient oversight of banks and other providers of financial

the nonbank affiliates of the insured entity through a limited enterprise supervision authority. This authority would ensure that the insured depository is protected from affiliate risk, but it would not be as onerous as consolidated regulation administered through the BHC Act.[81]

Enterprise supervision would allow the regulator to collect information about the parent holding company and its affiliates and their relationship to the insured entity directly. It would do this by giving the regulator additional authority—beyond that needed by the regulator of small, noncomplex depository institutions—to monitor, assess and act to control the risks imposed on the insured institution by other parts of the organization. The purpose of enterprise supervision would be to enhance the effectiveness of the firewalls separating the insured entity from its parent and affiliates and ensure that the federal safety net is not extended to uninsured entities of the conglomerate.

This regulator would also apply safety-and-soundness regulation to nondepository financial institutions or organizations that are large or complex and that pose a contingent liability to the government. Fannie Mae, Freddie Mac, and the FHLBs would fall into this category, for example.

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services. . . Some activities, practices, and intercompany dealings that affect the distribution of risk across the organization may go unnoticed if there is singular reliance on a functional approach. This suggests a need for some coordination and attention to interstitial concerns, such as maintaining accurate information regarding all operations in the organization, and monitoring compliance with the rules on intercompany dealings . . . "

[81] In 1987, an FDIC study concluded that banking companies could be allowed to offer a wider variety of products because banks could be insulated from the risks associated with nonbank affiliates without the need to spin a regulatory web around the entire organization. (FDIC (1987), 101-102). Also see: Kwast (1996), 746.

Regulator for federal deposit insurance programs. This agency would be the regulator for all federal deposit insurance programs. It would administer deposit insurance and receivership functions and would maintain its backup supervisory and enforcement authority over insured depository institutions. The safety-and-soundness regulators would be expected to coordinate their activities as related to problem institutions and to provide routine supervisory findings and information to this agency. In addition, this agency would have authority to examine those companies that provide significant services to depository institutions. The purpose of this authority would be to ensure that potential problems at a large service provider would be caught early enough to avoid system-wide problems for its depository institution clients that might ultimately affect the deposit insurance fund(s).

Role of the central bank. Although under this model the Federal Reserve would no longer have a direct role in the supervision of depository institutions, it would maintain and even expand its role in controlling systemic risk wherever systemic risk might occur in the financial system. At a recent conference, for example, Franklin Raines discussed the need for having a single umbrella financial regulator that would monitor systemic-risk issues and set broad policies to control that risk.[82] He suggested that this regulator would cover all financial institutions with on-balance-sheet assets greater than $100 billion. Although he did not cite the Federal Reserve as this regulator, the Federal Reserve is an obvious choice because of its role in promoting financial stability and its history of intervening in crises involving systemic risk within the financial system.

[82] Raines (2004), 3.

To fulfill this role, the Federal Reserve would have backup authority to intervene in financial markets to ensure financial stability. It would retain a supervisory interest in financial institutions that were deemed to pose an ongoing systemic risk to the financial system regardless of whether such institutions were supervised by another federal regulator. The list of these institutions would be distinguished by their activities as well as their size. Examples would be institutions with a substantial market position in a financially critical market, such as providers of a significant portion of payments-clearing services.[83]

Antitrust enforcement. Antitrust enforcement would be administered by either the DOJ or the Federal Reserve. An argument for having the Federal Reserve maintain this function is that in applying the antitrust statutes, the Federal Reserve would be able to consider the likely effects of consolidation on systemic risk. Conversely, antitrust enforcement could be placed solely within the purview of the DOJ, and the Federal Reserve could make its views known if it believed there were systemic risk implications.

Dual-banking and the role of the states. States would maintain their role as regulator and supervisor of all state-chartered institutions. For state-chartered institutions that did not have a federal safety-and-soundness regulator, states would be the sole safety-and-soundness regulators. For state-chartered institutions that were federally regulated and supervised, states would share regulatory responsibilities with their federal counterparts.

[83] Litan, in FDIC (2003a).

Conclusion

Reform of the U.S. financial regulatory system is far from assured. Matters are complicated by the dual system for regulating financial services firms. State regulators—including banking commissioners, states' attorneys general and others—compete with their federal counterparts in the regulation and supervision of financial services firms. In addition, state regulators are the sole supervisors of insurance companies, since the United States has no national charter for these firms.

The dynamic tension created by the presence not only of state regulators but also of multiple federal regulators has led many banking commentators to observe that nothing will change the regulatory structure of the financial services industry unless the politics of the current system are taken into consideration. Unlike citizens of other countries, who may not worry about concentrations of power, U.S. citizens have demonstrated a clear preference for decentralization. Further, it is commonly said that regulatory reform in the United States will be very hard to achieve without a big event to propel it forward. Although some tinkering around the edges may be possible, wholesale change—which would require congressional action—is not likely in the absence of a crisis that would minimize battles over turf and unite the entrenched constituencies.

That said, a number of industry observers have speculated that product convergence, or what Schooner and Taylor have termed functional despecialization, could provide a powerful argument for regulatory consolidation in the United States.[84] Indeed, many of the countries opting for regulatory consolidation have cited concerns over an apparently increasing divergence

[84] Schooner and Taylor (2003), 317-346.

between their old regulatory structure and the financial industry that the structure was responsible for regulating. The main factors hastening the divergence are financial innovation, a growing similarity between financial products, the widespread availability of new information technologies, and globalization.[85]

This paper has provided background and a framework for thinking about the issues involved in restructuring the federal financial regulatory system. It has reviewed past proposals and investigated ways in which other countries are restructuring their systems. Although many observers of the banking system doubt that the U.S. system will ever undergo restructuring, the financial services industry continues to evolve and, as it does so, questions continue to be raised as to whether the current regulatory system is up to the challenge. The task of legislators, regulators and others is to be sure that the regulatory system can accommodate financial change yet promote the regulatory objectives of ensuring safety-and-soundness, fostering efficiency and competition, and protecting consumers, all the while maintaining the stability of the financial system. Whether a restructuring of the federal financial system will eventually occur remains to be seen.

[85] De Luna Martinez and Rose (2003).

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Appendix

Proposals for Regulatory Restructuring

This appendix briefly describes the 24 major proposals for regulatory restructuring that have been made (but not acted on) since the bulk of the federal regulatory system was instituted in the early 1930s.

1. Brookings Study. In the 1930s, the Brookings Institution analyzed the federal bureaucracy for a Senate committee. Among the recommendations was one to reorganize the bank regulatory structure. The FDIC would have become the principal federal bank regulator, the OCC would have been abolished, and the Federal Reserve's examination of and supervisory responsibilities for state banks would have been transferred to the FDIC.

2. Hoover Commission. In 1949, three Hoover Commission task forces recommended that federal bank regulatory authority be centralized. One task force wanted to transfer the FDIC to the Federal Reserve, the second wanted to transfer the OCC to the Federal Reserve, and the third wanted to fold both the FDIC and the OCC into the Federal Reserve. The commission itself opted for a fourth approach, recommending that the FDIC be transferred to the Treasury Department.

3. Commission on Money and Credit. In 1961, the Commission on Money and Credit recommended that the functions of the FDIC and the OCC be transferred to the Federal Reserve.

4. Advisory Committee on Banking. In 1962, the OCC's Advisory Committee on Banking proposed eliminating the Federal Reserve's bank supervisory role. All supervisory authority relating to national banks would have been exercised by the OCC. All supervisory authority relating to state banks would have been exercised by the FDIC, which would have been placed within the Treasury Department.

5. Patman Bill. A proposal in 1965 by House Banking Committee Chairman Wright Patman, H.R. 6885, would have consolidated all federal bank regulation, including deposit insurance functions, in the Treasury Department.

6. Hunt Commission. In 1971 the Hunt Commission, formally titled the Presidential Commission on Financial Structure and Regulation, recommended the establishment of three new independent agencies: (1) the Administrator of National Banks, which would have replaced the OCC; (2) the Administrator of State Banks, which would have assumed the supervisory functions of the FDIC and the Federal Reserve; and (3) the Federal Deposit Guarantee Administration, which would have incorporated the FDIC, the FSLIC, and the credit union insurance agency.

7. Compendium of Major Issues in Bank Regulation. In 1975 the Senate Banking Committee commissioned a series of papers on issues of structural reform from preparers outside the government. Several papers recommended that the FDIC become the primary federal bank supervisor, mainly because the deposit insurer has ultimate responsibility for all bank supervisory activities.

8. Wille Proposal. In testimony before Congress in 1975, FDIC Chairman Frank Wille proposed the creation of a five-member Federal Banking Board to administer the deposit insurance system. He also called for a Federal Supervisor of State Banks to assume thc combined supervisory functions of the FDIC and the Federal Reserve vis-à-vis state banks.

9. FINE Study. In 1975, the House Banking Committee held a series of hearings on regulatory structure. The product of the hearings was a four-volume work titled *Financial Institutions and the Nation's Economy (FINE) "Discussion Principles.*" The study recommended the establishment of a Federal Depository Institutions Commission to administer all supervisory functions of the FDIC, the Federal Reserve, the OCC, the FHLBB, and the NCUA. Insurance functions would be handled by a subsidiary agency within the commission.

10. Senate Governmental Affairs Committee Proposal. In 1977, the Senate Governmental Affairs Committee recommended the consolidation of the bank regulatory agencies into a single agency. The Consolidated Banking Regulation Act of 1979 would have merged supervisory functions into a five-member Federal Bank Commission.

11. Deposit Insurance in a Changing Environment. In a 1983 study, the FDIC recommended the merger of the FSLIC into the FDIC. In addition, the FDIC recommended that it be removed from all regulatory functions not directly related to safety and soundness. The bank and thrift regulatory and supervisory functions of the Federal Reserve Board, the OCC, and the FHLBB would be consolidated in a new separate agency. The FDIC would have the authority to conduct examinations, require reports, and take enforcement actions, but it would limit its attention to problem and near-problem institutions.

12. Bush Task Group. In 1984, the Task Group on Regulation of Financial Services, chaired by then–Vice President Bush, produced *Blueprint for Reform*. The recommendations would have reduced the number of agencies involved in day-to-day bank supervision from three to two. A new Federal Banking Agency (FBA) would continue the OCC's supervisory responsibilities. The Federal Reserve would take over supervision of all state-chartered banks except banks in states where the state supervisory authorities were "certified" to perform the function themselves. Except for about 50 international-class holding companies, the federal supervisor—the FBA or the Federal Reserve—of a bank would also supervise the parent holding company. The Federal Reserve would supervise the internationals. The FDIC would lose day-to-day supervisory authority; its responsibilities would be confined to providing deposit insurance, although it would be able to examine troubled banks in conjunction with their primary supervisor. Finally, functional regulation would play a role in that enforcement of antitrust and securities laws would be transferred to the Justice Department and the Securities and Exchange Commission, respectively.

13. Depository Institutions Affiliation Act (DIAA). The DIAA was a piece of legislation that languished in several Congresses in the 1980s. The act would have established a National Financial Services Committee consisting of the chairmen of the Federal Reserve, the FDIC, the SEC, and the Commodity Futures Trading Commission; the Secretaries of Commerce and the Treasury; the Comptroller of the Currency; and the Attorney General. The committee would seek to establish uniform principles and standards for the examination and supervision of financial institutions and other providers of financial services.

14. National Commission on Financial Institution Reform, Recovery and Enforcement. In Subtitle F, Title XXV, of the Comprehensive Crime Control Act of 1990, Congress created an independent commission to examine the thrift crisis of the l980s and to make appropriate recommendations. In its study, *Origins and Causes of the S&L Debacle: A*

Blueprint for Reform, the commission recommended that federal deposit insurance be limited to accounts in "monetary service companies," which would be able to invest only in short-term, highly rated market securities. A corollary recommendation was that the FDIC be made the sole federal insurer of depository institutions and the sole federal charterer and regulator of insured institutions. The OCC and the OTS would be eliminated. The FDIC would remain an independent agency but would be required to consult regularly with the Federal Reserve and make available to it all pertinent information about the condition of insured depository institutions. The Federal Reserve would appoint an independent Oversight Board to evaluate new and proposed programs, statutes, rules, and regulations. The Oversight Board would not take actions on its own but would report its findings and recommendations to Congress and the public.

15. **Modernizing the Financial System.** The regulatory structure recommendations of the 1991 Treasury-led study of the federal deposit insurance system largely followed the recommendations of the 1984 Bush Task Force. The four federal banking regulators—the Federal Reserve, the FDIC, the OCC, and the OTS—would be reduced to two, and the same federal regulator would be responsible for both a bank holding company and its subsidiary banks. A new Federal Banking Agency (FBA) within the Treasury Department would succeed to the responsibilities of both the OCC and the OTS. The FBA would also be responsible for the bank holding company parents of national banks. The Federal Reserve would have responsibility for all state-chartered banks and their parent holding companies. The Federal Reserve and the FBA would jointly agree on bank holding company regulatory policies. The FDIC would focus solely on the deposit insurance system and on the resolutions of troubled banks and thrifts.

16. H.R. 1227, the Bank Regulatory Consolidation and Reform Act. This 1993 bill, introduced by Representative Jim Leach, would have combined the OCC and the OTS into a separate independent federal banking agency that would regulate all federally chartered thrifts and their holding companies as well as national banks and their holding companies unless a holding company's assets exceeded $25 billion. The FDIC would regulate all state-chartered thrifts and their holding companies as well as state-chartered banks and their holding companies unless a holding company's assets exceeded $25 billion. Bank holding companies with assets above $25 billion, and their subsidiary banks, would be regulated by the Federal Reserve.

17. H.R. 1214, S. 1633, the Regulatory Consolidation Act. These 1993 bills, introduced in the House by Banking Committee Chairman Henry Gonzalez and in the Senate by Banking Committee Chairman Donald Riegle, would have consolidated federal bank and thrift regulatory functions into a single independent commission, the Federal Banking Commission. The OCC and the OTS would be abolished. The Federal Reserve would continue to manage monetary policy. The FDIC would continue to administer deposit insurance and exercise conservatorship and receivership functions, but its regulatory duties with respect to nonmember banks would be transferred to the commission. The bills differed in several respects. The main differences were the number of members on the independent commission and the composition of the FDIC Board of Directors. Under the House bill, the commission would have seven members: the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chairman of the FDIC, and four public members, one of whom would serve as the commission's chairman. The five-member FDIC Board of Directors would be composed of the chairman of the commission and four public members, one of whom would be the FDIC Chairman. (And the commission would have a consumer division to enforce consumer protection laws.) Under the Senate bill, the commission would have five members: the Secretary of the Treasury or his or her designee, a

Federal Reserve Board Governor, and three public members. The five-member FDIC Board would be composed of the Secretary of the Treasury or his or her designee, the chairman of the commission, and three public members, one of whom would be the FDIC Chairman.

18. Clinton Administration. In a November 1993 document titled "Consolidating the Federal Bank Regulatory Agencies," the Treasury Department proposed the consolidation of federal bank and thrift regulatory functions in an independent Federal Banking Commission (FBC). The proposal is similar to the approaches of H.R. 1214 and S. 1633. The FDIC would be limited to insurance functions, including the handling of failed and failing institutions. The Federal Reserve would keep its central banking functions but would have no primary bank regulatory responsibilities, although it would be able to participate in the FBC's examination of a limited number of banking organizations—the ones most significant to the payments system. The states would continue to regulate the banks they charter. Thus, state banks would be regulated by both the FBC and the states. The FBC would have five members: a chairperson appointed by the president; the Secretary of the Treasury or his or her designee; a member of the Federal Reserve Board, selected by the Board; and two other presidentially appointed members. An early 1994 revision of the proposal expanded the Federal Reserve Board's participation to include joint examinations of a sampling of both large and small banks, joint examinations of the largest bank holding companies, lead examinations of holding companies whose main bank is state-chartered, and backup authority to correct emergency problems in any of the 20 largest banks.

19. Federal Reserve Board. In January 1994, Federal Reserve Board Governor John P. LaWare advanced a five-component plan. First, the OCC and the OTS would be merged. The resulting agency might be called the Federal Banking Commission (FBC). Second, the FDIC would be removed as a regulator of healthy institutions. It would keep its insurance functions. Third, examination by charter would be replaced by the principle of one organization, one examiner. The FBC would examine organizations whose lead depository institution is a national bank or thrift. The Federal Reserve would examine organizations whose lead depository institution is state chartered. Fourth, as an exception to the previous point, a small number of financially important organizations would be treated somewhat differently. The holding companies and nonbank subsidiaries would be regulated and supervised by the Federal Reserve, whereas the bank subsidiaries would be regulated and supervised by the primary regulator of the lead bank. Fifth, the Federal Reserve would remain in charge of holding company rulemaking and supervision as well as the regulation of foreign banks. The FBC would write rules for national institutions, and the Federal Reserve would write rules for state institutions, but the two regulators would be required to make their rules as consistent (each with the other's) as possible.

20. H.R. 17, the Bank Regulatory Consolidation and Reform Act. This 1995 bill, introduced by House Banking Committee Chairman Jim Leach, is similar but not identical to Leach's 1993 proposal (H.R. 1227). The OCC and the OTS would be consolidated into a new independent agency, the Federal Banking Agency, which would regulate all federal depository institutions (except those that are subsidiaries of depository institution holding companies regulated by the Federal Reserve or the FDIC); savings and loan holding companies whose principal depository institution subsidiary is a federal savings association; and bank holding companies that have consolidated depository institution assets of less than $25 billion and whose principal depository institution subsidiary has a federal charter. The FDIC would regulate all state-chartered nonmember depository institutions except those that are subsidiaries of depository institution holding companies regulated by the Federal Banking Agency or the Federal Reserve; savings and loan holding companies whose principal depository institution subsidiary is a state savings associations; and bank holding companies that have consolidated depository institution assets of less than $25 billion and whose principal depository institution subsidiary is a state-chartered nonmember depository institutions. The Federal Reserve would regulate all state-chartered Federal Reserve–member depository institutions except those that are subsidiaries of depository institution holding companies regulated by the Federal Banking Agency or the FDIC; bank holding companies that have consolidated depository institution assets of less than $25 billion and whose principal depository institution subsidiaries are state-chartered Federal Reserve–member depository institutions; and all bank holding companies with consolidated depository institution assets of $25 billion or more.

21. Federal Deposit Insurance Act Amendment of 1995. House Banking Committee Vice Chairman Bill McCollum included a regulatory restructuring proposal in a bill (H.R. 1769) he introduced to capitalize the Savings Association Insurance Fund and spread the debt service costs of the Financing Corporation to all FDIC-insured institutions. The McCollum proposal would consolidate the OCC and the OTS into a new independent agency similar to that in the Leach bill (H.R. 17).

22. The Thrift Charter Convergence Act of 1995. Representative Marge Roukema included a regulatory restructuring proposal in a bill (H.R. 2363) she introduced to capitalize the Savings Association Insurance Fund and spread the debt service costs of the Financing Corporation to all FDIC-insured institutions. The Roukema proposal provides for the conversion of federal savings associations into banks; the treatment of state savings associations as banks for purposes of federal banking law; the abolition of the OTS; and the transfer of OTS employees, functions, and property to the OCC, the FDIC, and the Federal Reserve, as appropriate.

23. General Accounting Office. In testimony before Congress in May 1996, the General Accounting Office, based largely on a review of foreign systems of bank regulation, made four recommendations for changes in the U.S. bank regulatory system. First, the number of federal agencies with primary responsibilities for bank oversight should be reduced by consolidating the OTS, the OCC, and the FDIC's primary supervisory responsibilities into a new agency. Second, the Federal Reserve and the Treasury Department should be included in some fashion in bank oversight. Third, the FDIC should have the necessary authority to protect the deposit insurance funds. Fourth, mechanisms to help ensure consistent oversight and reduce regulatory burden should be incorporated into the regulatory system.

24. Financial Modernization, 105th Congress. Financial modernization was a topic of broad interest in the 105th Congress (1997–1998). As reported out of the House Banking Committee in June 1997, H.R. 10, the Financial Services Competition Act of 1997, combined elements of several bills, including the House version of the Depository Institution Affiliation Act and a Department of the Treasury proposal. Regarding regulatory restructuring, H.R. 10 would have abolished the OTS, merging it into the OCC, and would have created a National Council on Financial Services composed of the Secretary of the Treasury; the Chairmen of the Federal Reserve Board, the FDIC, the SEC, and the CFTC; the Comptroller of the Currency; a state securities regulator; a state banking supervisor; and two presidential appointees with experience in state insurance regulation. These regulatory restructuring measures were not in the version of H.R. 10 that was passed by the House in May 1998, and they were not revived in later versions of the bill.